Michigan Law Review

Volume 58 | Issue 2

1959

Taxation - Federal Income Tax - Commission Received by Life Insurance Agent on Policies Purchased by Him Held to be Taxable Income

Roger W. Findley S.Ed.
University of Michigan Law School

TAXATION—FEDERAL INCOME TAX—COMMISSION RECEIVED BY LIFE INSURANCE AGENT ON POLICIES PURCHASED BY HIM HELD TO BE TAXABLE INCOME—Taxpayer was agent for eleven life insurance companies. From two of them he purchased policies on the lives of his business partner, three key employees, and his children. He paid the regular premiums and subsequently received standard first-year and renewal commissions. When taxpayer did not include these in his gross income, the Commissioner assessed deficiencies and was sustained by the district court. On appeal, *held,* affirmed. A commission received by a life insurance agent on a policy purchased by him is taxable income.[1] *Ostheimer v. United States,* (3d Cir. 1959) 264 F. (2d) 789, cert. den. 80 S.Ct. 61 (1959).

Two theories can be advanced in support of the position that the commissions were not taxable income. One would analogize them to standard discounts available to employees. Generally, when an individual employee makes a bargain purchase of property from his employer, the difference between the fair market value and the price paid is includible in gross income.[2] An exception exists, however, where the purchase involves the employer's merchandise and the price differential represents a regular discount available to employees.[3] In the principal case the court found that the commissions were not really discounts and therefore did not fit within the exception. In support of this holding the court stressed, first, that the obligation to pay the commissions arose from the same contractual terms which required payment of compensation for selling insurance to third persons, and second, that a statute prohibited partial rebates of premiums.[4] In keeping with the general philosophy expounded

[1] The decision is in line with previous treasury rulings: T.D. 2137, 17 T.D. 48 (1915), explained in G.C.M. 10486, 1932-1 Cum. Bul. 14; Rev. Rul. 55-273, 1955-1 Cum. Bul. 221.

[2] Treas. Reg. §1.61-2 (d) (2); Commissioner v. Smith, 324 U.S. 177 (1945).

[3] Treas. Reg. §31.3401 (a)-1 (a) 10. An example is where a salaried employee in a clothing store gets his suits at a 10% reduction in price.

[4] Pa. Stat. Ann. (Purdon, 1954) tit. 40, §§275, 276, and 471 are typical in requiring insurance companies and agents to sell at fixed prices without rebates of premiums or

in *Commissioner v. Glenshaw Glass Co.*,[5] it would seem that the court correctly restricted the exception to savings clearly intended by the employer to be regular employees' discounts.

The second possible immunizing theory is that the commissions should be exempt as "imputed" income. The term "income" in the code means income arising from market-place transactions, not that produced and directly consumed by the taxpayer himself.[6] Thus the farmer who grows his own food[7] and the housewife who does her own cleaning do not thereby produce taxable income. A closer analogy is the case of the stockbroker who buys securities on the open market for his own account, thus saving the amount of the usual broker's commission. This saving is not taxable income.[8] The crucial issue in the principal case is whether the agent, in writing his own policies, was working directly for himself or for the insurance companies. The resolution of this issue turns upon the position from which the transaction is viewed. The court chose to evaluate it from the point of view of the insurance companies. It made no difference to them whether the agent sold to third persons or to himself; in either case the companies made the same profit and were willing to pay the usual compensation. Considered in this manner the principal case is clearly distinguishable from that of the stockbroker buying securities for his own account, since in the latter case there is no separate entity for which the taxpayer can be said to be performing a personal service.[9] On the other hand, the distinction fades if the transaction is viewed from the position of the insurance agent. His job is to sell insurance to others, not to himself. When he does purchase a policy, he can either let some other agent write it or do the work himself and save the amount of the commission. The agent who writes his own policy undoubtedly has the same attitude as the broker who handles his own stock purchase: each does the work himself to save the usual commission. Nevertheless, regardless of how the agent may

commissions. The no-rebate statute not only refutes the contention that the commissions were discounts but also forecloses the possibility that the agent made bargain purchases of any kind. The insurance companies could not lawfully negotiate bargain purchases.

5 348 U.S. 426 at 429-430 (1955). The Court said that by defining "gross income" as broadly as it did in §22 (a) of the 1939 code, Congress intended "to tax all gains except those specifically exempted."

6 See note, 1959 DUKE L. J. 476.

7 Homer P. Morris, 9 B.T.A. 1273 at 1278 (1928) (dictum).

8 See Benjamin v. Hoey, (2d Cir. 1944) 139 F. (2d) 945 at 946, where taxpayer, a partner in a stock brokerage firm, bought and sold securities for his own account. He paid to the firm the full amount of the usual commissions, totaling $66,947, and received 38% of that amount back as firm profits. *Held,* the $25,440 is not taxable income. "What one pays to one's self cannot be part of one's income."

9 Harvey M. Toy, 11 P-H B.T.A. and T.C. Mem. Dec. ¶42,452 (1942) is contra to Benjamin v. Hoey, note 8 supra, and a good example of how the concept of a "separate entity" can result in confusion. Taxpayer was a partner in a real estate brokerage firm. He purchased several properties for his own account through the partnership, paying the usual commissions. *Held,* taxpayer is taxable on his distributive share of such commissions.

regard his alternative courses of action, it is difficult to escape the fact that by purchasing insurance from a company which he represents rather than from the agent of another company, he is performing a service for his own company. For this service the company compensates him, and compensation for personal services is taxable income. Thus it seems that the court reached the proper result. This reasoning applies equally to other cases in which an employee receives a commission for a sale in which he himself was the buyer. For example, if a real estate salesman purchases a house for himself through his employer, a broker, and subsequently receives a salesman's share of the commission which the employer collects from the listing seller, it would seem that the employee should be taxed on his share of the commission.[10]

The further question arises whether the above reasoning should be applied where the recipient of a commission is a broker—i.e., an independent contractor—rather than an agent or employee. As was stated previously, a stockbroker who purchases on the open market securities for his own account is not taxed on the commission he saves.[11] If in the case posed at the end of the preceding paragraph the real estate broker himself had purchased the house, the amount of his commission ought not to be taxable income. This result would seem to be dictated by the fact that the broker could have simply offered the seller the difference between the asking price and the usual commission, since the broker in his personal capacity is in a position to negotiate for a bargain purchase. The most difficult case seems to be that of an insurance broker who purchases a policy and receives the standard commission from the issuing company.[12] Although it might at first glance seem desirable to treat insurance brokers in the same manner as other brokers, the reasoning in the above discussion regarding taxation of commissions received by an insurance agent is equally applicable in the case of a broker. He performs a service for the company for which it pays the usual compensation, and the statute forbidding premium rebates refutes any contention that the broker could or did negotiate a bargain purchase. Thus it seems that the insurance broker, unlike other types of brokers, should be taxed on commissions received in connection with his own purchases in the same manner as commission employees.

Roger W. Findley, S.Ed.

[10] In Kenneth W. Daehler, 31 T.C. 722 (1959), note, 1959 DUKE L. J. 476, now on appeal to the Court of Appeals for the Fifth Circuit, the Tax Court held on these facts that the salesman was not taxable on his share of the commission, the reasoning being that he had simply purchased the property at a reduced price.

[11] See note 8 supra.

[12] In Sol Minzer, 31 T.C. 1130 (1959), note, 45 VA. L. REV. 748 (1959), now on appeal to the Court of Appeals for the Fifth Circuit, the Tax Court held on these facts that the commission received by the insurance broker was not taxable income. The court stressed that taxpayer was not an employee and analogized the taxpayer to the stockbroker and real estate broker who buy for their own accounts.